BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities And Their Holding Companies And Non-Regulated Affiliates.	Rulemaking 05-10-030 (Filed October 27, 2005)

COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES

I. INTRODUCTION

Pursuant to the *Opinion Amending Order Instituting Rulemaking,* Decision (D.) 06-06-062 ("Amended OIR"), the Division of Ratepayer Advocates (DRA) hereby submits its comments on the Commission's proposed revisions to the Affiliate Transaction Rules and General Order (GO) 77-L. These proposed revisions are necessary to protect ratepayers from adverse effects of self-dealing and cross-subsidization between utilities and affiliates as the regulatory setting has altered since the Commission adopted the Affiliate Transaction Rules in 1998. Several factors, including the energy crisis in 2000-2001, the recent repeal of the Public Utilities Holding Company Act of 1935 (PUHCA), and the potential for conflicts of interest given the highly integrated relationship among affiliated entities, call for the update of the Commission's Affiliate Transaction Rules. Accordingly, DRA's recommendations take these changes into consideration, bearing in mind the Commission's goals "to make the utility's capital requirements a first priority," "to ensure that the utilities meet their public service

obligations at the lowest reasonable cost," and "to ensure that the utilities do not favor or otherwise engage in preferential treatment of their affiliates."

II. Possible Solutions

The Commission offers six proposals set forth in the Amended OIR Sections 3.3.1 through 3.3.6. DRA's comments and recommendations on each of the proposals are discussed below.

Protecting and Preserving the Utility's Financial Health (Section 3.3.1)

1. A "Ring-fencing" Rule Should Be Adopted

In Section 3.3.1(a) of D.06-06-062, the Commission is "considering whether to adopt a rule requiring 'ring fencing' to insulate the financial health of a utility from any financial risks posed by its holding company or affiliates." (D.06-06-062, p. 19.)

The Commission should focus on adopting specific ring-fencing rules. The experience of Portland General Electric Company is a successful example of ring-fencing, as discussed in the Energy Law Journal's article, "PUHCA's Gone: What Is Next For Holding Companies?" (27 Energy L. J. 1, pp. 21-22.) The article describes several conditions the Oregon Commission imposed on Enron's acquisition of Portland General Electric in 1997. Later, when the electricity industry was plagued by market manipulation, these provisions effectively protected Portland General Electric from Enron's bankruptcy in 2001. The need for ring-fencing in the era of holding companies and affiliates is real, especially now in the wake of the repeal of PUHCA. Not only will ring-fencing rules help protect the California utilities from being harmed by the risks facing their holding companies and affiliates, but ring-fencing may also help the regulated utility earn better credit ratings than its unregulated parent and affiliates.

The Fitch Ratings agency addressed the benefits of ring-fencing techniques and their effect on utility ratings. According to a special report issued by Fitch in February 2004, the financial condition of a utility's holding company and affiliates

often has significant effects on its rating.[1] ("Fitch Utility Regulatory Survey of State Public Service Commissions," Global Power/North America Special Report, Fitch Ratings, February 2004, p. 1.) The report explains,

> A normal operating subsidiary carrying out ongoing business generally cannot achieve this complete isolation from the risks of the corporate parent, but a strong ring-fence permits wider separation of the ratings of related companies. When one subsidiary approaches default, ring-fencing efforts become increasingly important, and the notching between parent and subsidiary ratings can widen considerably (e.g., Enron Corp. and Portland General Electric Company). (Fitch 2004 Report, p. 2.)

For these reasons, adopting specific ring-fencing rules are critical and would further the Commission's goal of "protecting the financial health of a utility."

Currently, the danger exists that if a holding company engages in risky practices or corporate malfeasance, the utility's captive ratepayers would not be protected from significant losses incurred by that holding company. Thus, new rules protecting the financial health of California's energy utilities and their ratepayers should be a top priority for the Commission. The Commission recognized this risk when it imposed conditions on Southern California Edison's ("SCE") request to reorganize under a holding company in D.88-01-063. The Commission reasoned, "[t]here is always the risk when affiliates and the utility do business together, holding company organization or not, that improper allocations will result in higher costs of service and, therefore, higher rates than necessary." (D.88-01-063, p.22.) Accordingly, DRA recommends the Commission revisit the conditions it imposed in D.88-01-063 as a starting point to develop appropriate ring-fencing rules.

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[1] The Fitch special report can be found on FERC's website: http://www.ferc.gov/EventCalendar/Files/20050222123050-1-28-05%20EC%20Attach-Fitch%20Survey%20of%20PSCs%202%2004.pdf

2. Financial Event Which Reduces Equity Ratio By At Least 1% Below Commission-approved Ratio

The Commission proposes that all energy utilities be required to file an advice letter or application for waiver whenever a financial event reduces its equity ratio by at least 1% below the Commission-approved ratio. (D.06-06-062, p. 20.) This requirement is currently in place for Pacific Gas & Electric Company ("PG&E"). DRA concurs with the Commission's proposal to apply this requirement to the other major energy utilities, provided parties are allowed to protest following regular Commission procedures.

3. Annual Reporting to Ensure Compliance With First Priority Condition

The Amended OIR states in order to ensure compliance with the first priority condition that underlies each of the holding company decisions, the Commission is considering a requirement that Respondents prepare annual reports to update the information submitted in response to this OIR. (D.06-06-062, p. 20.)

On this proposal, DRA concurs as long as the annual reports submitted are meaningful and useful. However, DRA further recommends the Commission engage in a review of the current rules providing for waiver. The Commission notes it also has the authority to grant an exemption from its own rules in individual circumstances, when warranted. (D.06-06-062, p. 21.) Establishing the Commission's ability to effectively detect, measure, and reverse, if necessary, the adverse impact of affiliate transactions on the utility's financial health should be the key parts of this review.

B. Strengthening Separation Rules Governing a Utility its Unregulated Affiliates and the Holding Company (Section 3.3.2)

1. Application to Holding Companies

The Commission has made it clear that the Affiliate Transaction Rules apply to utility holding companies. (D.06-06-062, p. 20.) The Amended OIR suggests two approaches to implementing this important clarification: First, expressly state that all of the existing rules apply to utility / holding company relationships.[2] Second, specify in each rule whether or not that rule applies to the holding company relationship, and if it does, whether limited exceptions should be allowed for circumstances unique to the holding company. DRA believes the second approach is better.

Regarding the first approach—to expressly state that all of the existing rules apply to utility / holding company relationships—DRA believes the specific problems noted in Section 3.2.1 would not be addressed. As the Amended OIR notes, Rule I.A. already defines the word "affiliate" to include "the utility's parent or holding company," but is limited "to the extent the holding company is engaged in the provision of products or services as set out in Rule II.B. (D.06-06-062, p. 13.) However, the utilities interpret the rules as inapplicable to the relationship between them and their respective holding companies. (D.06-06-062, p. 13.) To solve this problem, the Commission should address and modify Rule II.B, entitled "Applicability." DRA suggests the following revisions to Rule II:[3]

> A. These Rules shall apply to California public utility gas corporations and California public utility electrical corporations, *and their affiliates,* subject to regulation by the California Public Utilities Commission.

[2] The Commission indicates this approach recognizes the specific exceptions to the rules (e.g., for taxes, financial reports) in the Corporate Support section (Rule V.E) exist because of holding company needs.

[3] Suggested edits include additions in italics, and deletions in strike-out.

> B. For purposes of a combined gas and electric utility, these Rules apply to all utility transactions with affiliates ~~engaging in the provision of a product that uses gas or electricity or the provision of services that relate to the use of gas or electricity~~, unless specifically exempted below. For purposes of an electric *or gas* utility, these Rules apply to all utility transactions with affiliates. ~~affiliates engaging in the provision of a product that uses electricity or the provision of services that relate to the use of electricity~~. ~~For purposes of a gas utility, these Rules apply to all utility transactions with affiliates engaging in the provision of a product that uses gas or the provision of services that relate to the use of gas~~.

The 1998 requirement to "engage in the provision of a product that uses gas or electricity or the provision of services that relate to the use of gas or electricity" was tied to PUHCA language. With the repeal of the 1936 Act, the limitation is obsolete. Now, holding companies will have an unfettered ability to invest in unrelated businesses, and companies completely outside of the electricity and gas industries will be able to acquire regulated utility assets.[4] (*See* 27 Energy L. J. 1, p. 15.) For that reason, the scope of utility transactions with non-regulated affiliates or holding companies will be amplified. Correspondingly, the Commission already has authorization to review utility transactions that might adversely affect the interests of the ratepayers. (Pub. Util. Code § 314(b).)

In addition to the Commission's Affiliate Transaction Rules which, as the Commission has made clear, are applicable to the utilities' holding companies, D.02-01-037 clarified that the conditions imposed on the holding companies by Commission decisions constitute valid Commission Orders enforceable in Commission proceedings. (*Decision on Motions to Dismiss for Lack of*

[4] Public Utilities Code Section 854 limits the merger, acquisition, or control of any electric, gas, or telephone utility by providing that any such activity is subject to Commission authorization.

Jurisdiction [D.02-01-037], 2001 Cal. PUC LEXIS 7, p. *1.) Moreover, the Commission also has jurisdiction pursuant to Public Utilities Code Section 1708 to reexamine, modify, or add to the conditions as necessary to protect the pubic interest. (Id at *2.) In May 2004, the First Appellate District Court of Appeal affirmed the Commission's decision in D.02-01-037. (*PG&E Corp. v. California Public Utilities Commission; Office of Ratepayer Advocates, et al.,* 118 Cal. App. 4th 1174.)

2. Elimination of Sensitive Shared Activities

DRA agrees the Commission should consider a reduction in the number of shared activities eligible for support by utility affiliates. (D.06-06-062, p. 21.) Specifically, DRA agrees the Commission should exclude the shared activities of financial planning, regulatory affairs, lobbying, legal, and / or risk management from shared services. While the holding company system may be effective for maximizing efficient business practices, these synergies must be measured against the inherent conflicts of interests, which often render the Affiliate Transaction Rules—which prevent self-dealing and cross-subsidization at the expense of utility ratepayers—meaningless. The holding company must not be allowed to profit by providing the utility with personnel who may not have the interests of the utility as their main priority. The current rules illustrate the potential for conflicts of interests harmful to the utility and its ratepayers. For example, Rule V.E. states,

> Joint utilization shall not allow or provide a means for the transfer of confidential information from the utility to the affiliate, create the opportunity for preferential treatment or unfair competitive advantage, lead to customer confusion, or create significant opportunities for cross-subsidization of affiliates. In the compliance plan, a corporate officer from the utility and the holding company shall verify the adequacy of the specific mechanisms and procedures in place to ensure the utility follows the mandates of this paragraph, and to ensure the utility is not utilizing joint corporate support services as a conduit to circumvent these Rules.

Realistically, the Commission must recognize that the best mechanisms or procedures in the world may not prevent the transfer of confidential information between the utility and its affiliate using the same personnel for shared financial planning, regulatory affairs, lobbying, legal, and risk management. Given the inherent conflicts of interest, it is simply unreasonable to expect employees that have a financial incentive in the affiliates' performance not to act on confidential utility information in a manner favorable to the affiliates. To protect ratepayers and to ensure a level playing field for competitors, the Commission should adopt rules calling for separate employees and facilities providing services in the sensitive areas of financial planning, regulatory affairs, lobbying, legal services and risk management. With different employees and facilities housing these services and providing them separately to the utility and its affiliates, the need for a compliance plan is minimized. However, DRA recognizes that the Commission will be under immense pressure to continue to allow utilities and their affiliates to share services in areas where confidential information necessarily flows from the utility to the affiliate. In case the Commission does not revise Rule V.E to discontinue shared services in these sensitive areas, then, at a minimum, the Commission should revise the rule so that the utility and holding company are no longer responsible for developing a compliance plan to verify the adequacy of its mechanisms and procedures. Instead, the Commission should create its own specific mechanisms and procedures to ensure compliance. Utilities and holding companies implementing these Commission-adopted compliance procedures should have the plans reviewed and approved by Energy Division.

In addition, the use of temporary or intermittent assignments of its employees also opens the door to potential conflicts. Under the current Affiliate Transaction Rules, there is no ban on the use of temporary or intermittent assignments with the exception of utility employees engaged in marketing. Originally, the Commission crafted a comprehensive ban in the Affiliate

Transaction Rules in D.97-12-088.[5] However, in D.98-08-035, the California energy utilities successfully argued for removal of the total ban, replacing it with the current Rule G.2.e., which limits temporary or intermittent assignments to marketing employees. The Commission reasoned a total ban "may disadvantage utilities and their affiliates in other competitive markets, especially internationally." (*Opinion on Certain Petitions for Modification of Decision 97-12-088* [D.98-08-035], 1998 Cal. PUC LEXIS 594, p. *10.)

Given the Commission's experience with utility holding companies, it is time to reassert a total ban on temporary or intermittent assignments of utility personnel to its affiliates and vice-versa. The arguments set forth by the utilities and adopted by the Commission back in 1998 are not applicable in the current regulatory setting. With the repeal of PUHCA, there are no longer any regulatory barriers to utility affiliates operating in competitive markets. The Commission needs to limit the potential for self-dealing by requiring greater physical separation between the utility, its affiliates, and the holding company—a strict ban on temporary and intermittent assignments of employees is integral to this endeavor.

Under the current Affiliate Transaction Rules, it is possible for a utility to temporarily assign an employee from its holding company to conduct negotiations with an affiliate. In this scenario, it is difficult to evaluate whether the parties' negotiations were conducted at arms-length, even when full disclosure of the assignment is in compliance with the current Affiliate Transaction Rules. Nevertheless, current Commission policy frustrates the opportunity to conduct meaningful investigations upon review. For example, under D.90-09-088, the Commission has allowed an Expedited Application Docket process for approval of bilateral contracts between a utility and affiliate qualifying facilities (QFs). While DRA notes that peer review groups (PRG) and Third Party Evaluators provide

[5] Under D.97-12-088, Rule V.G.2.e of the Affiliate Transaction Rules states, "A utility shall not make temporary or intermittent assignments, or rotations to its affiliates." This rule was removed upon Petition for Modification, as explained in D.98-08-035.

significant insight for outside participants to review utility procurement prior to the filing of an application, they cannot substitute for the Commission's review of whether the prices were just and reasonable. Moreover, PRG and Third Party Evaluators are limited to the role of a consultant, and do not establish precedent in Commission proceedings.

To prevent potential self-dealing issues from arising in such a case, DRA recommends a total ban on the temporary or intermittent use of holding company (or affiliate personnel) in any part of the negotiations with an affiliate on behalf of the utility. The Commission should propose to delete current Rule G.2.e and replace it with language stating, "A utility shall not make any temporary or intermittent assignments, or rotations to its affiliates, nor shall a holding company or affiliate make any temporary or intermittent assignment or rotation to the utility." Such a rule will help prevent harm to both ratepayers and competitors from potential self-dealing and conflicts of interest due to sharing of confidential utility information with affiliates.

3. Commission Exemption in Individual Circumstances

Provided the Commission strengthens the Affiliate Transaction Rules, DRA supports the Commission retaining authority to grant exceptions to its own rules in individual circumstances. (D.06-06-062, p. 21.) However, political pressure will bear on the Commission to grant waivers and exemptions for such reasons as "economic development." Considerations of protection of ratepayer and competitor interests are equally important and must be fully explored. Therefore, waivers and exceptions must be made as the result of clear rules and transparent proceedings. This transparency can be accomplished by a Commission requirement that requests for waivers, exemptions, and / or exceptions must be made by applications, so that potential protestants and intervenors will have full notice and opportunity to be heard. Ratepayers can only be protected from self-

dealing and cross-subsidization if all relevant facts are brought to the Commission's attention.

C. Increasing Reporting Requirements Regarding Interactions Between a Utility and its Affiliates (Section 3.3.3)

1. Minutes of Affiliate Interactions

The Amended OIR states the Commission is considering a requirement that a utility create minutes for any meetings or discussions between the utility and its holding company or affiliates, and that the minutes be made available to the Commission or its staff. (D.06-06-063, p. 22.) DRA agrees with the Commission that increased reporting requirements are necessary.

2. Distance between Auditor and Subject of Audit

To provide greater distance between the auditor and the subject of the audit, the Commission is also considering that Commission staff, rather than the utility, direct the annual Affiliate Transaction Rules compliance audits. (D.06-06-062, p. 22.) DRA considers this recommendation a critical step to establish independence. Currently, allowing the company to direct the audit of the Affiliate Transaction Rules impairs audit independence. The extent of audit scope should be determined by the auditor, absent any direction from company management. Finally, any audit conducted by the Commission and its staff should be subject to a review upon request by interested parties.

D. Prohibiting Utility Procurement from Affiliates Without Prior Commission Approval (Section 3.3.4)

DRA supports the utility filing an application requesting pre-approval from the Commission of any proposed long-term gas supply contracts between the utility and its affiliate. (D.06-06-062, p. 22.) DRA opposes any requirement that a utility procure natural gas supplies from competitors of affiliates to justify similar procurement from affiliates. Any gas supply purchased under long-term

arrangements—whether between the utility and an affiliate or non-affiliate—must be evaluated on its own individual merits. The utility may file an application for pre-approval for any such gas supply from non-affiliates. Competitors who believe they have been or are being treated unfairly vis-a-vis utility affiliates should file a complaint with the Commission, showing they could have supplied gas or power at more favorable terms than those used to procure gas or power from utility affiliates. Such a showing then shifts the burden to the utility to prove that they have negotiated fairly with the competitor in comparison to the affiliate. Of course, the Commission can and should elect to investigate such matters on its own initiation where facts show the utility-affiliate procurement rules or relationship may have been abused to the detriment of ratepayers.

E. Reiterating Cooperation Required in Discovery from Holding Companies and Utility Affiliates (Section 3.3.5)

The Commission is considering an amendment to the Affiliate Transaction Rules and/or GO77-L to expressly reiterate the Commission's broad statutory right to obtain information from the utility holding companies and affiliates. The obligation to provide holding company information is also one of the major conditions the Commission imposed when it authorized the utilities' reorganization into holding companies. (See D.06-06-062, p. 23.) The Public Utilities Code presently allows the Commission staff broad discovery powers under Sections 314(a) and 582.[6] The Commission's statutory authorization extends largely to a utility's holding company and affiliates, as specified by Section 314(b):

[6] Public Utilities Code § 314(a): "The commission, each commissioner, and each office and person employed by the commission may, at any time, inspect the accounts, books, paper, and documents of any public utility." §582: "Whatever required by the commission, every public utility shall delivery to the commission copies of any or all maps, profiles, contracts, agreements, franchises, reports, books, accounts, papers, and records in its possession or in any way relating to its property or affecting its business…"

> [Section 314(a)] also applies to inspections of the accounts, books, papers, and documents of any business which is a subsidiary or affiliate of, or a corporation which holds a controlling interest in, an electrical, gas, or telephone corporation and the subsidiary, affiliate, or holding corporation on any matter *that might adversely affect the interests* of the ratepayers of the electrical, gas, or telephone corporation.

(Pub. Util. Code § 314(b) (Emphasis added).) Section 583[7] treats and protects certain information furnished to the Commission as confidential.

DRA believes cooperation by the utilities and their affiliates is a vital part of protecting ratepayers from self-dealing and cross-subsidization between the utility and affiliates. If the holding company does not allow access to information, it is impossible to review affiliated transactions on the basis of the full and fair record required by due process. It is tantamount to a corporation telling its external auditors they can't see certain information. The Commission must adopt and impose strict penalties in the event the holding company blocks access for whatever reason to requested information. The holding company (and its affiliates) will have the capability to significantly delay providing requested information to the point where the information becomes useless, or even refuse to provide this information despite the rules. This will allow the utility's affiliates to obstruct the Commission's ability to protect ratepayers. Regardless of whether the Commission ultimately sides with the utility, DRA, or other intervenors over a disputed issue, access to information in a timely manner is a basic tenet of a fair process. Ensuring this access is one of the Commission's most important roles in the holding company regulatory environment.

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[7] No information furnished to the commission by a public utility, or any business which is a subsidiary or affiliate of a public utility, or a corporation which holds a controlling interest in a public utility, except those matters specifically required to be open to public inspection by this part, shall be open to public inspection or made public except on order of the commission or a commissioner in the course of a hearing or proceeding. Any present former officer or employee of the commission who divulges any such information is guilty of a misdemeanor.

F. Increasing Reporting of Compensation Packages from Utilities and Requiring Information from Holding Companies and Utility Affiliates (Section 3.3.6)

The Amended OIR discusses revisions to GO 77-L to require utilities and their affiliates (in the western United States energy market) and their holding companies to include the following information on an annual basis: for executive officers or employees earning $250,000 or more per annum, details of the total, aggregate compensation package; disclosure of the proportion of that compensation paid, directly or indirectly, by a utility's ratepayers; and, for utilities, a statement explaining the method for determining compensation to a utility's executive officers and employees and explaining how that method avoids tying compensation to the profitability of the utility's holding company. (D.06-06-062, p. 23.)

DRA concurs with the Commission's above recommendation for more detailed disclosure.

Respectfully submitted,

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August 7, 2006

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES** in **R.05-10-050** by using the following service:

[x] **E-Mail Service:** sending the entire document as an attachment to all known parties of record who provided electronic mail addresses.

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Executed on August 7, 2006 at San Francisco, California.

/s/ PERRINE D. SALARIOSA
Perrine D. Salariosa

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address and/or e-mail address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

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